FILE COPY

No. 80.

OCT 10 193
CHARLES ELMORE CR

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932.

MURPHY OIL COMPANY, a Corporation,
Petitioner,

vs.

DAVID BURNET, Commissioner of Internal Revenue,
Respondent.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS, NINTH CIRCUIT.

BRIEF FOR PETITIONER.

RANDOLPH E. PAUL,
Attorney for Petitioner,
40 Wall Street,
New York City.

FERRIS D. STONE,
THOMAS R. DEMPSEY,
A. CALDER MACKAY,
KENYON F. LEE,
BRADNER W. LEE,
EDWARD S. REID, JR.

Pandick Press, Inc., 22 Thames St., New York. U. S. A.

SUBJECT INDEX.

PAGE

I. Opinions 1

II. Jurisdiction 2

III. Statement of the Case:

(1) History of Case 3

(2) Facts Involved 4

(3) Question Presented 6

IV. Argument:

Statute and Regulations Involved 6

Preliminary Discussion 8

I. The transaction between the taxpayer, Murphy Oil Company, and the Standard Oil Company of California, evidenced by lease dated December 1, 1913, did not constitute a sale of taxpayer's mineral properties and the bonus of $5,173,595.18 received by the Murphy Oil Company was not purchase price, and, therefore, did not represent a return of its capital 18

II. The amended regulation of the Commissioner, as upheld by the Circuit Court of Appeals, requiring the reduction of petitioner's depletable base to the extent of the bonus, violates the statutory concept of depletion, in basing depletion upon receipt of income rather than upon actual exhaustion of the mineral reserves 21

PAGE

III. Neither the apportionment clause in the depletion provision of the 1918 Act, nor the decision of this Honorable Court in Lynch *vs.* Alworth-Stephens Co., 267 U. S. 364, justifies any elimination from the taxpayer's depletable base on account of the bonus received by it under its lease 33

IV. The Commissioner's amended regulation is arbitrary, capricious and invalid:

(A) Impossibility of Proving Royalties Expected to be Received 47

(B) Differentiation Between Depletion in Bonus and Non-Bonus Cases 50

(C) Requirement that Excess Depletion be Returned as Income in Event of Termination 51

(D) Conclusion 53

V. The history of Article 215, as amended, of Regulations 45, and the time of its injection into this case puts upon the Commissioner the burden of pleading and proving the allocation contended for by him 53

Authorities Cited.

Cases.

	PAGE
Alexander *vs.* King, 46 F. (2d) 235 (C. C. A. 10th, 1931), reversing 38 F. (2d) 256	20
Bankers' Trust Co. *vs.* Bowers, 295 Fed. 89 (C. C. A. 2nd, 1923)	29
Berg *vs.* Commissioner, 33 F. (2d) 641 (App. D. C., 1929), affirming 6 B. T. A. 1287, certiorari denied, 280 U. S. 598	20
Blair *vs.* Chicago, 201 U. S. 400	35
Brushaber *vs.* Union Pacific R. R. Co., 240 U. S. 1	52
Burkett *vs.* Commissioner, 31 F. (2d) 667 (C. C. A. 8th, 1929), affirming 7 B. T. A. 560, certiorari denied, 280 U. S. 565	20
Burnet *vs.* Logan, 283 U. S. 404	30, 50
Burnet *vs.* Thompson Oil & Gas Co., 283 U. S. 301, reversing 40 F. (2d) 493 (C. C. A. 10th, 1930), in effect affirming 15 B. T. A. 993	9, 10, 11, 12, 13, 24, 26, 27
Butler, James M., 19 B. T. A. 718	20
Cooper, A. T., 7 B. T. A. 798	52
Crile *vs.* Commissioner, 55 F. (2d) 804 (C. C. A. 6th, 1932), certiorari applied for May 5, 1932	20
DeGanay *vs.* Lederer, 250 U. S. 376	10, 23, 31
Douglas Properties, Inc., 21 B. T. A. 347	20
Doyle *vs.* Mitchell Bros. Co., 247 U. S. 179	9
Eisner *vs.* Macomber, 252 U. S. [illegible]	9
Goldfield Consolidated Mines Co. [illegible] Scott, [illegible] U. S. 126	24
Haverstick, Edward E., 13 B. T. A. 837	20
Herold *vs.* Commissioner, [illegible] F. (2d) 942 (C. C. A. 5th, 1930), affirming and reversing 17 B. T. A. 933	18

PAGE

Iselin *vs.* United States, 270 U. S. 245 55

Knapp, Kittie A., 7 B. T. A. 790 52

Lucas *vs.* American Code Company, Inc., 280 U. S. 445 2

Lynch *vs.* Alworth-Stephens Co., 267 U. S. 364, 23, 32, 33, 37, 38, 41, 42

Merchants' Loan & Trust Co. *vs.* Smietanka, 255 U. S. 509 9

Morrill *vs.* Jones, 106 U. S. 466 32

New Creek Co. *vs.* Lederer, 295 Fed. 433 (C. C. A. 3rd, 1924), affirming 288 Fed. 99 20

Night Hawk Leasing Co. *vs.* Burnet, 57 F. (2d) 612 (App. D. C., 1932), reversing 19 B. T. A. 258, 33, 37, 39, 44, 45, 46

O'Day Investment Co., 13 B. T. A. 1230 20

Old Colony Trust Company, *et al.*, Executors *vs.* Commissioner, 279 U. S. 716 2

Palmer *vs.* Bender, 57 F. (2d) 32 (C. C. A. 5th, 1932), affirming 49 F. (2d) 316 18

Pugh *vs.* Commissioner, 49 F. (2d) 76 (C. C. A. 5th, 1931), in effect affirming 17 B. T. A. 429, certiorari denied, 52 S. Ct. 22 18

Robinson *vs.* Lundrigan, 227 U. S. 173 55

Rosenberger *vs.* McCaughn, 25 F. (2d) 699 (C. C. A. 3rd, 1928), certiorari denied, 278 U. S. 604 20

Stanton *vs.* Baltic Mining Co., 240 U. S. 103 ..... 10, 20

Stratton's Independence, Limited *vs.* Howbert, 231 U. S. 399 ..... 9, 20, 24, 53

People *ex rel.* Studebaker Corp. *vs.* Gilchrist, 244 N. Y. 114 17

United States *vs.* Biwabik Mining Co., 247 U. S. 116 20

United States *vs.* Ludey, 274 U. S. 295 ..... 10, 23, 28

United States *vs.* Ninety-Nine Diamonds, 139 Fed. 961 (C. C. A. 8th, 1905), affirming 132 Fed. 579 35

PAGE

Von Baumbach *vs.* Sargent Land Co., 242 U. S. 503.... 20, 24

Waller *vs.* Commissioner, 40 F. (2d) 892 (C. C. A. 5th, 1930), affirming 16 B. T. A. 574, certiorari denied, 51 S. Ct. 101..... 18

Weiss *vs.* Wiener, 279 U. S. 333, reversing 27 F. (2d) 200 (C. C. A. 6th, 1928), which reversed 17 F. (2d) 650 20

Woolford Realty Co., Inc. *vs.* Rose, 52 S. Ct. 568.... 29

Work *vs.* Mosier, 261 U. S. 352..... 20

STATUTES.

Corporation Tax Law of 1909..... 53

Revenue Act of 1913, Section II, Subdivisions B & G (b) (38 Stat. 114, 166)..... 54

Revenue Act of 1916, Part I, Title I, Section 5, Paragraph Eighth (a), and Section 12 (a), Paragraph Second (a) (39 Stat. 756)..... 54

Revenue Act of 1917, Section 212 (40 Stat. 300)..... 54

Revenue Act of 1918, Section 234 (a) (9) (40 Stat. 1057) 6, 10, 16, 22, 33, 37, 54

Revenue Act of 1918, Section 214 (a) (9) (40 Stat. 1057) 54

Judicial Code, Section 240 (a), as amended by the Act of February 13, 1925, Title 28, U. S. C. A., Sec. 347 2

REGULATIONS AND RULINGS.

Regulations 33 revised, Article 170..... 41
Regulations 45, Article 210 25
Regulations 45, Article 214 50

PAGE

Regulations 45, Article 215 (a) (1920 Edition), 5, 7, 22, 28, 29, 54
Regulations 45, Article 215, as amended 48, 53, 55, 56
Regulations 45, Article 215 (a), as amended 32, 51
Regulations 45, Article 215 (d) 31, 51
Regulations 45, Article 229 25
Regulations 62, Articles 210, 229 25
Regulations 65, Articles 211, 231 25
Regulations 69, Article 229 25
Regulations 74, Article 249 25
A. R. M. 148, C. B. I-1, p. 186 25
A. R. R. 1147, C. B. I-2, p. 138 25
Treasury Decision 2447, unpublished 41
Treasury Decision 3938, C. B. V-2, p. 117, 5, 8, 29, 31, 36, 51, 54

MISCELLANEOUS.

Hearings before Committee on Ways and Means, House of Representatives, on Proposed Revenue Act of 1918, Part I 41, 42

Hearings before Senate Finance Committee, 65th Congress, 2nd Session, H. R. 12,863 42

Rules of Practice of the United States Board of Tax Appeals, Rule 14 56

Rules of Practice of the United States Board of Tax Appeals, Rule 30 57

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932.

No. 80.

MURPHY OIL COMPANY, a Corporation,
Petitioner,

vs.

DAVID BURNET, Commissioner of
Internal Revenue,
Respondent.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS, NINTH CIRCUIT.

BRIEF FOR PETITIONER.

I.

Opinions.

The opinion of the Board of Tax Appeals (R. II-231-247)* is reported in 15 B. T. A. 1195.

* Since the record is a consolidation of the record in two appeals, there is a duplication of page numbers. Therefore the figure I is used where reference is had to the pages of the record in No. 6388 and the figure II is used where reference is had to the pages of the record in No. 6459.

The opinion of the United States Circuit Court of Appeals, Ninth Circuit (R. II-268-295), is reported in 55 F. (2d) 17.

II.

Jurisdiction.

The statutory provision which is believed to sustain the jurisdiction of this Court is Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, Title 28, U. S. C. A., §347. The judgment of the Circuit Court of Appeals was entered on January 11, 1932 (R. II-297). The date on which the application for the appeal was presented was May 16, 1932. This case is on certiorari from the Circuit Court of Appeals for the Ninth Circuit. Since Section 240 (a) of the Judicial Code as amended makes it competent for the Supreme Court of the United States to review by certiorari any case in a circuit court of appeals, certiorari having been granted, the jurisdiction is established.

The following cases sustain the jurisdiction in that they show that the appellate jurisdiction of the Supreme Court of the United States applies to cases originating in the United States Board of Tax Appeals, and that specifically Section 240 (a) of the Judicial Code applies to such cases. *Old Colony Trust Company, et al., Executors* vs. *Commissioner,* 279 U. S. 716; *Lucas* vs. *American Code Company, Inc.,* 280 U. S. 445.

III.

Statement of the Case.

(1)

History of Case.

This controversy was originated by a deficiency letter issued by the Commissioner of Internal Revenue (referred to herein as the Commissioner) dated February 6, 1926 (R. I-18), proposing a deficiency in income and profits tax against petitioner for the years 1919 and 1920 amounting to $398,400.53 (R. I-18). Petitioner appealed to the Board of Tax Appeals which, on January 17, 1930, rendered its decision eliminating the deficiency proposed (R. I-66). Although the deficiency was eliminated the decision of the Board was in favor of the petitioner taxpayer on only one of the two issues contested before the Board, referred to herein as the bonus and expense points. The contentions of the taxpayer prevailed as to the bonus point and the contentions of the Commissioner prevailed as to the expense point.

Separate appeals were taken by the Commissioner and the taxpayer to the Circuit Court of Appeals, Ninth Circuit (R. II-253 and I-63), and that Court on January 11, 1932, handed down decisions reversing the Board of Tax Appeals on the bonus point and affirming the Board on the expense point, thus making the ultimate decision on both points in favor of the Commissioner (R. II-296). Rehearing was denied (R. II-297). The taxpayer then abandoned its contentions on the expense point. Certiorari was granted by order filed May 31, 1932 (R. II-304).

(2)

Facts Involved.

Prior to March 1, 1913, the taxpayer petitioner acquired in fee two parcels of real estate in California, commonly referred to as the Coyote and Whittier properties (R. I-47). Oil and gas were found upon the properties and, on March 1, 1913, and subsequently, they were both producing. On December 1, 1913, the taxpayer leased the properties to the Standard Oil Company of California for a term of forty years for the purpose of developing and producing oil and gas (R. I-50). The lessor reserved a one-fourth royalty and the lessee agreed to and did pay in installments from 1913 to 1918, inclusive, and "independently of and in addition to royalties", a so-called bonus of $5,500,000.00. The payment of this bonus was not dependent upon production (R. I-59). Personal property was transferred in connection with the lease to which the Commissioner allocated $326,404.82, leaving a net bonus of $5,173,595.18 (R. I-51). The Commissioner allocated this bonus between the properties, $4,517,402.70 to the Coyoté property and $656,192.48 to the Whittier property (R. I-52).

Since the properties were acquired prior to March 1, 1913, the basis of the taxpayer for computing depletion is the value on March 1, 1913. That value has been found by the Commissioner to be $15,710,899.52 for the Coyote properties and $1,450,207.08 for the Whittier properties, and is not in dispute (R. II-272).*

---

* Since the opinion of the Circuit Court of Appeals mentions only the Coyote properties (see Depletion Schedule, R. II-270 and 271) the figure in the text above for the Coyote properties will be used in this brief with the understanding that the same principles are also applicable to the depletion of the Whittier properties.

Pursuant to Article 215 (a) of Regulations 45 as then in effect (1920 edition) and before amendment by Treasury Decision 3938, C.B. V-2, p. 117, this bonus was treated in the deficiency letter issued by the Commissioner as a return of capital and the entire bonus was applied in reduction of the value at March 1, 1913, which was the basis for depletion (R. I-18). The petitioner appealed to the Board on the ground that the bonus was not a *return of capital* but was *income* (R. I-6). The Commissioner answered and this issue was tried. Subsequent to the trial the Commissioner "confessed error" in his brief (R. I-58), changing his position in accordance with the then recently issued amendment of Article 215 (a) of Regulations 45 by Treasury Decision 3938, *supra,* which provided that bonuses were to be treated not as a return of capital but as income and that a certain amount of depletion, according to the formula provided in the amended regulation, should be allocated to the bonus income as received irrespective of when oil was produced from the properties.

The Board held that the revised regulation was invalid (R. I-60). It likewise impliedly rejected the principle of the earlier regulation. It sustained the petitioner's method of computing depletion. In reversing the Board of Tax Appeals the Circuit Court of Appeals approved the amended regulation* and its principle of offsetting depletion against the bonus (R. II-290). The effect of the decision of the Circuit Court of Appeals is to affirm the deficiency originally proposed of $398,400.53.

---

* The opinion of the Circuit Court of Appeals as reported in the record (R. II-268 to 295), contains an error in the sentence (at page 290): "The regulation is not only in conflict with the statute, but directly conforms thereto." The word "not" was omitted after the word "only."

(3)

Question Presented.

Petitioner, Murphy Oil Company, owned the fee of the Coyote and Whittier oil properties on March 1, 1913. The March 1, 1913 value of these properties is not in dispute. This value represents the capital of petitioner on March 1, 1913, which by virtue of the statute in the manner therein provided it should be allowed to recover tax-free. When such recovery is allowed through depletion, this capital sum is called "Depletable Base."

The ultimate issue herein involved is whether, in determining petitioner's depletion deductions for the years 1919 and 1920, its depletable base (the March 1, 1913 value) should be reduced by the amount of the bonus received by petitioner under the lease dated December 1, 1913.

IV.

ARGUMENT.

Statute and Regulations Involved.

Sec. 234 (a) (9) of the Revenue Act of 1918 (40 Stat. 1057), reads as follows:

> "Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: • • •
>
> "(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements,

according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided, further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

Before amendment Article 215 (a) of Regulations 45, in its 1920 edition, provided (italics ours):

"(a) Where a lessor receives a bonus or other sum in addition to royalties, *such bonus or other sum shall be regarded as a return of capital to the lessor,* but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The

bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

By Treasury Decision 3938, *supra,* this article was on November 13, 1926, amended to read as follows (italics ours):

"(a) Where a lessor receives a bonus in addition to royalties, *there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received.* Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received."

* * * * * * *

"(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

Preliminary Discussion.

The taxpayer, under its lease with the Standard Oil Company, dated December 1, 1913, received in addition to

royalties in oil a cash bonus of $5,500,000.00, part of which has been allocated by the Commissioner to the sale of personal property transferred to the Standard Oil Company by the lease (R. I-51), leaving a net bonus of $5,173,595.18. The instant case is concerned with the proper treatment of this bonus for income tax purposes, particularly as regards depletion.

The question is not merely a problem of depletion but reaches into the fundamental purposes of Congress in its desire to protect taxpayers from a tax on capital.

Income has been generically defined as "'. . . the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through sale or conversion of capital assets . . .'"*

Machinery has been devised in connection with the third type of income enumerated in the quotation—"profit gained through sale or conversion of capital assets"—to avoid a tax upon the taxpayer's investment in capital assets sold or converted. In the case of outright dispositions of property this protection is a matter of constitutional necessity.** If the disposition is gradual, as it is when mineral properties are operated, the protection is to be deduced from the fundamental intent of Congress to afford equality of treatment to all taxpayers and to give by statute in the case of gradual disposition of capital what is given by the constitution in the case of outright disposition. For these

---

* *Eisner* vs. *Macomber*, 252 U. S. 189, at page 207; *Merchants' Loan & Trust Co.* vs. *Smietanka*, 255 U. S. 509; *Stratton's Independence, Limited* vs. *Howbert*, 231 U. S. 399; *Doyle* vs. *Mitchell Bros. Co.*, 247 U. S. 179.

** See particularly *Burnet* vs. *Thompson Oil & Gas Co.*, 283 U. S. 301, at page 307, reversing 40 F. (2d) 493 (C. C. A. 10th, 1930), and in effect affirming 15 B. T. A. 993, and citing *Doyle* vs. *Mitchell Bros. Co.*, 247 U. S. 179.

reasons the question involved herein goes to basic concepts of the income tax law and is of outstanding importance.

Depletion, as the word is used in the income tax statutes, is limited in its application to the exhaustion of natural resources. Whatever it may be in the field of economics or accountancy, depletion is for income tax purposes a creature of the statute, since its allowance is a matter of grace and not of right. *

Technically, the problem in the instant case is solely one of the correct interpretation of the above quoted statutory provision. However, the statute itself does not define depletion; it prescribes no method of computing depletion. The problem of statutory interpretation, therefore, requires a resort to general principles.

It is the position of the taxpayer in the instant case that the word "depletion," as used in Section 234 (a) (9), must be interpreted, under the well-established rule of statutory construction, according to its ordinary, familiar and natural meaning,** and that that meaning is established beyond argument by court decisions and the practice of the Bureau of Internal Revenue. While the meaning of the word is the basic point to be considered and finally dictates the conclusion to be reached, it is necessary to consider the question not only from the viewpoint of the statute and the decided cases but also to set forth exactly how the problem arises in the instant case.

At the outset it should be noted that the depletion deduction is kindred to the depreciation deduction.*** Nevertheless, the methods of computing depreciation and deple-

---

* *Stanton* vs. *Baltic Mining Co.*, 240 U. S. 103; *Burnet* vs. *Thompson Oil & Gas Co., supra.*

** *DeGanay* vs. *Lederer*, 250 U. S. 376.

*** *United States* vs. *Ludey*, 274 U. S. 295, 303.

tion are generally different. Depreciation is in most cases computed on the so-called "straight-line" basis. Under this method the depreciation base (cost or value at March 1, 1913) is divided by the number of years of remaining useful life of the property and the quotient is the annual allowance. This method is based upon the fiction that depreciation occurs evenly year by year and that the depreciation allowance for a particular year is a proportional part, on a time basis, of the depreciation base.

This method of computing depreciation is dictated by necessity. It is usually impossible to measure the amount of depreciation which has occurred in a fixed period of time. It is usually impossible to say how much a building has exhausted its useful life in one year as compared with another year.

However, absolute exactness is possible in allocating depletion over the years and this fact explains the disparity between the methods adopted for computing *depletion* and *depreciation.* The method adopted for computing depletion is the unit-of-production method and, as applied by the Commissioner, involved the use of a diminishing balance.* The two members of the equation are: (1) the depletable base (cost or value at March 1, 1913), and (2) the number of mineral units or reserves in the property at that date. Once these two factors are determined, the unit-of-production method measures with absolute accuracy the depletion allowance for a particular period of time, since it is determined by the actual production of the period, which can be computed with complete precision.

---

* This method has been approved in the only case reaching this Court involving the depletion *method* as distinguished from more general problems of depletion. See quotation, *infra,* page 26, from *Burnet* vs. *Thompson Oil & Gas Co., supra.*

It should be noted in addition that any method of computing depletion other than the unit-of-production method, and particularly the straight-line method, completely misrepresents the physical fact of exhaustion which is the fundamental reason for the depletion deduction. It is impossible, as of March 1, 1913, to estimate the useful life of a mineral property in terms of years; further, depletion in the sense of exhaustion of the reserves of a mineral property ordinarily takes place unevenly over the years, rendering the straight-line method absolutely valueless as a system for determining the depletion allowance for the year.

These general principles furnish the background for the method adopted in computing the annual depletion allowance and are highly important because of the fixed principle that the income tax is one "for annual periods."*

Under the unit-of-production method the depletable base of the taxpayer is divided by the number of mineral units in the property and the quotient is the depletion unit. This unit is then multiplied by the reserves taken from the property in the year; the product is the depletion allowance for the year.

The factors, therefore, which are necessary to compute the depletion allowance for mineral properties are: (1) the depletable base, and (2) the number of units of mineral reserves to which this base is applicable. The diminishing balance method involves the reduction each year of (1) the depletable base by the amount of depletion allowed for the year, and (2) the mineral reserves by the number of units extracted during the year.

This is the method which the Commissioner has prescribed for lessors where no bonus is involved. It is the

---

* *Burnet* vs. *Thompson Oil & Gas Co., supra,* at page 306.

method which this Honorable Court has approved in *Burnet* vs. *Thompson Oil & Gas Co., supra.** It is the method which this petitioner is advocating. The Commissioner, however, in the instant case has used a different method because of the payment of a bonus to the taxpayer. He has treated the bonus as a return of capital and applied it in reduction of the depletable base (March 1, 1913 value) of the oil reserves.

A simple example expressed in round numbers will serve to illustrate the difference between the Commissioner's method and that advocated by the petitioner herein. In the example following the first column represents the petitioner's method, and the second column shows the effect of the Commissioner's action when a bonus is injected into the imaginary case furnished by the example:

---

* See quotation from the Board opinion in this case on page 24.

	Petitioner's Method	*Commissioner's Method*
1. Depletable base (value at March 1, 1913)	$2,000,000.00	$2,000,000.00
2. Reserves at March 1, 1913, in barrels	4,000,000	4,000,000
3. Value per barrel (Depletion unit)	$ 0.50	$ 0.50
4. Production March 1, 1913, to December 1, 1913, in barrels	100,000	100,000
5. Depletion sustained March 1, 1913, to December 1, 1913 (Item 4 times Item 3)	$ 50,000.00	$ 50,000.00
6. Depletable base remaining December 1, 1913 (Item 1 minus Item 5)	$1,950,000.00	$1,950,000.00
7. Bonus received	$ 500,000.00	$ 500,000.00
8. Depletable base remaining after receipt of bonus (Item 6 minus Item 7)	$1,950,000.00	$1,450,000.00
9. Remaining Reserves, December 1, 1913, in barrels (Item 2 minus Item 4)	3,900,000	3,900,000
10. Depletion Unit (Item 8 divided by Item 9)	$ 0.50	$ 0.3718
11. Production December 1, 1913, to December 31, 1918, in barrels	2,000,000	2,000,000
12. Depletion sustained December 1, 1913, to December 31, 1918 (Item 10 times Item 11)	$1,000,000.00	$ 743,600.00
13. Depletable base remaining January 1, 1919 (Item 8 minus Item 12)	$ 950,000.00	$ 706,400.00
14. Remaining Reserves (Item 9 minus Item 11)	1,900,000	1,900,000
15. Depletion Unit (Item 13 divided by Item 14)	$ 0.50	$ 0.3718
16. Production in 1919, in barrels	100,000	100,000
17. Depletion sustained in 1919 (Item 15 times Item 16)*	$ 50,000.00	$ 37,180.00

* The above example illustrates what the Commissioner has done in the instant case. The Commissioner's method as applied in the instant case is not in strict mathematical accordance with the amended regulation in that depletion deductions subsequent to the date of the lease were computed upon a production basis rather than the royalties received basis required by the amended regulation. The effect, however, of the application of the method prescribed in the regulations is the same as in the above example in that it allocates depletion deductions to the bonus payments and not to the actual exhaustion of reserves.

The bonus received of $500,000 does not reduce the depletable base under the petitioner's method, items 7 and 8, to $1,450,000 as it does under the Commissioner's method, because it was income and did not involve any exhaustion of the properties. This is the essential difference between the petitioner and the Commissioner in the instant case.

The loss in the depletion allowance for the year 1919 on account of the reduction of the deductible base by the bonus as per the above example is $12,820.00, the difference between the amounts in the two columns in item 17.

In the instant case the Commissioner has applied the bonus in reduction of the taxpayer's depletable base without, as the above example demonstrates, a corresponding decrease of the reserves (there being no production allocable to the bonus). The result is that the depletion unit is lowered, the depletion allowance is decreased, the taxpayer's income is increased, and the deficiency here in question is asserted.

Had the diminishing balance method been followed, during the period March 1, 1913 to January 1, 1919, the reduction of depletable base would have paralleled the reduction of the taxpayer's mineral reserves, leaving the depletion unit the same. There would not have been a reduction of the depletable base without a reduction of the oil of which it is the expression in dollars. Obviously since the taxpayer's capital is oil, it can be reduced only by the extraction of oil (or by being converted into monied capital through sale). The mere statement of the result of the Commissioner's action indicates its fallacy.

Under the diminishing balance method the depletion unit is the depletable base divided by the barrels of oil in the property. The barrels of production in a given period

are multiplied by this depletion unit to obtain the depletion allowance for the period. The depletable base is reduced by the depletion sustained and allowed. Correspondingly, the reserves are diminished by the production. The two constantly parallel each other. The result is a constant depletion unit.

When it is considered that the taxpayer's depletable base is oil expressed in dollars for the sake of convenience of computation (we must have, for tax purposes, a common unit of measurement, the dollar), it is apparent that the diminishing balance method is the correct one since it reduces the capital (oil) only when oil is extracted. The mere receipt of dollars is not indicative of return of capital.

The taxpayer's depletable base, which is the value of its properties at March 1, 1913, was $15,710,899.52. The production of the period March 1, 1913, to January 1, 1919, according to the diminishing balance method, would reduce this depletable base and would correspondingly reduce the taxpayer's mineral reserves, leaving the depletion unit the same. The Commissioner reduced the depletable base remaining as of January 1, 1919, not only on account of previously sustained depletion but also by the amount of the bonus *without any corresponding reduction of the reserves to which the depletable base was applicable;* he could not reduce the reserves since they were still in the property at January 1, 1919.

It is the contention of the taxpayer that the essential effect of this procedure of the Commissioner was to allocate *anticipatory* depletion to years when there has been no corresponding exhaustion of the property and that the procedure is based upon an unwarranted construction of Section 234(a)(9). In other words, the Commissioner by his

action has deprived the taxpayer of depletion to which it was entitled in 1919 and 1920 by allocating depletion to years prior thereto in accordance with a formula based upon *income from*, as distinguished from *exhaustion of*, the taxpayer's property.

The above preliminary discussion should be enough to show the injustice of applying the amended regulation. If it is argued in favor of the amended regulation that it works a more equitable result, the strictly legal answer is that a statute must be construed according to its terms and the intent apparent on its face.* However, it is obvious that the amended regulation does not work a more equitable result. The amended regulation under discussion was not promulgated until 1926. It superseded the regulation treating bonuses as a return of capital which went into effect in January, 1921. Prior to 1921 bonuses were treated not as a return of capital but as income and no depletion was allowed in respect thereto. The harsh result is obvious that taxpayers receiving bonuses in years when they were regarded as income and in which no depletion was allocable

---

* The above principle has been forcefully stated in *People ex rel., Studebaker Corp.* vs. *Gilchrist*, 244 N. Y. 114, at page 125, as follows:

> "* * * The taxing officers of the State are mere administrative agents. They may not devise new forms and methods of taxation, however convenient or useful. * * * Assessment, however handy, must find its warrant in the statute. A statute levying a tax will not be extended by implication beyond the clear import of its terms (Gould *v.* Gould, 245 U. S. 151, 153). If one method of assessment or collection is pointed out, the courts will not permit the application of another on the theory that the Legislature might just as well have chosen it, since in the final devolution of the burden the result will be the same, or, at worst, not widely different (U. S. *v.* Field, 255 U. S. 257; Stebbins *v.* Kay, 123 N. Y. 31; People *ex rel.*, Mutual Trust Co. *v.* Miller, 177 N. Y. 51). We take the statute as we find it."

thereto will never secure the benefit of the depletion allocable thereto in accordance with the amended regulation. In other words, taxpayers in this position have paid a tax on sums received, part of which under the amended regulation should be regarded as tax-free by way of depletion. Neither did such taxpayers secure the benefit of the return-of-capital theory underlying the 1920 edition of the regulations.

We shall now proceed tc a more detailed statement of the petitioner's position.

POINT I.

The transaction between the taxpayer, Murphy Oil Company, and the Standard Oil Company of California, evidenced by lease dated December 1, 1913, did not constitute a sale of taxpayer's mineral properties and the bonus of $5,173,595.18 received by the Murphy Oil Company was not purchase price, and, therefore, did not represent a return of its capital.

If the transaction of December 1, 1913, constituted a sale by the Murphy Oil Company to the Standard Oil Company, then the payments to be made by the Standard Oil Company, including the bonus, are purchase price and the treatment of them for income tax purposes would not involve the question of depletion at all since a person who has parted with property is no longer entitled to depletion with respect thereto.* The transaction cannot be half sale and

* See *Pugh* vs. *Commissioner*, 49 F. (2d) 76 (C. C. A. 5th, 1931), in effect affirming 17 B. T. A. 429, certiorari denied, 52 S. Ct. 22; *Herold* vs. *Commissioner*, 42 F. (2d) 942 (C. C. A. 5th, 1930), in effect affirming and reversing 17 B. T. A. 933; *Waller* vs. *Commissioner*, 40 F. (2d) 892 (C. C. A. 5th, 1930), affirming 16 B. T. A. 574, certiorari denied, 51 S. Ct. 101; *Palmer* vs. *Bender*, 57 F. (2d) 32 (C. C. A. 5th, 1932), affirming 49 F. (2d) 316.

half lease. Neither can the consideration moving to Murphy Oil Company be part purchase price and part rent or royalty; the bonus and the royalties in oil are either both purchase price or neither of them are. There can be no middle ground. It is desirable, therefore, at the outset to discuss the nature of the transaction.

The Commissioner recognizes that a lease of oil properties does not constitute a sale of the mineral products. He admitted in his brief before the Circuit Court of Appeals that the taxpayer's lease, dated December 1, 1913, did not constitute a sale. Indeed, his admission could not be otherwise in view of the terms of the lease itself, the following provisions of which clearly connote a lease and are positively inconsistent with a sale:

(1) The interest of the Standard Oil Company is limited in time to a term of forty years (R. II-186).

(2) The Murphy Oil Company reserves certain very substantial royalties (R. II-189 and 195).

(3) Various obligations are imposed upon the Standard Oil Company, such as the duty to drill wells (R. II-195).

(4) The parties have themselves expressed the intention that the instrument shall constitute a lease and not a sale (R. II-186).

(5) The instrument contains limitations upon assignment, underletting or subletting (R. II-217 and 218).

(6) The instrument provides for the division of the burden of payment of taxes (R. II-215).

(7) The instrument contains a forfeiture clause (R. II-205 and 208).

The foregoing provisions conclusively demonstrate that the instrument was a lease and not a sale. Therefore, the bonus was income* and the reduction of lessor's depletable base by the amount of the bonus is entirely without justification on the theory of return of capital.

---

* See *Work* vs. *Mosier,* 261 U. S. 352, which involved a bonus and the following cases which involved ordinary royalties from mineral properties: *Stratton's Independence, Limited* vs. *Howbert, supra; United States* vs. *Biwabik Mining Co.,* 247 U. S. 116; *Stanton* vs. *Baltic Mining Co., supra; Von Baumbach* vs. *Sargent Land Co.,* 242 U. S. 503. Additional authorities for this point are furnished by the several decisions of the lower federal courts, some of which involve the question whether royalties are taxable as the proceeds of a conversion of capital assets: *Alexander* vs. *King,* 46 F. (2d) 235 (C. C. A. 10th, 1931), reversing 38 F. (2d) 256; *Berg* vs. *Commissioner,* 33 F. (2d) 641 (App. D. C., 1929), affirming 6 B. T. A. 1287, certiorari denied, 280 U. S. 598; *Burkett* vs. *Commissioner,* 31 F. (2d) 667 (C. C. A. 8th, 1929), affirming 7 B. T. A. 560, certiorari denied, 280 U. S. 565; see also *Weiss* vs. *Wiener,* 279 U. S. 333, reversing 27 F. (2d) 200 (C. C. A. 6th, 1928), which reversed 17 F. (2d) 650; *Rosenberger* vs. *McCaughn,* 25 F. (2d) 699 (C. C. A. 3d, 1928), certiorari denied, 278 U. S. 604; *New Creek Co.* vs. *Lederer,* 295 Fed. 433 (C. C. A. 3d, 1924), affirming 288 Fed. 99. In addition, see the line of cases to the effect that bonuses in connection with ordinary non-mineral leases are income. *Crile* vs. *Commissioner,* 55 F. (2d) 804 (C. C. A. 6th, 1932), certiorari applied for May 5, 1932; *O'Day Investment Co.,* 13 B. T. A. 1230; *James M. Butler,* 19 B. T. A. 718; *Douglas Properties, Inc.,* 21 B. T. A. 347; *Edward E. Haverstick,* 13 B. T. A. 837.

POINT II.

The amended regulation of the Commissioner, as upheld by the Circuit Court of Appeals, requiring the reduction of petitioner's depletable base to the extent of the bonus, violates the statutory concept of depletion, in basing depletion upon receipt of income rather than upon actual exhaustion of the mineral reserves.

The contentions of the petitioner herein are in accordance with the decision of the Board of Tax Appeals which was reversed by the Circuit Court of Appeals. The Board of Tax Appeals held:

> (1) that the instrument of December 1st, 1913, was a lease and did not effect a sale of the taxpayer's properties;
>
> (2) that the taxpayer did not, in receiving the bonus, receive a return of capital but received income;
>
> (3) that the determination of the Commissioner in the deficiency letter was erroneous in treating the bonus as a return of capital and applying the same in reduction of the petitioner's depletable base; and
>
> (4) that neither could the Commissioner's deficiency be sustained on the theory of the amended regulation which provides that a certain amount of depletion is allowable in respect of the bonus, this theory being untenable because it constituted a "departure from the depletion concept."

The Board of Tax Appeals recognized that under the instrument of December 1, 1913, the bonus was payable "independently of and in addition to the royalties and other considerations" stated in the lease. The Board said (R. I-159):

"The bonus payment in the instant case was a part of the consideration paid for the lease. While expected production undoubtedly was considered in fixing the amount of the bonus, it is elementary under the laws governing such agreements that its payment did not, in anywise, depend upon, or relate to, production. The lessee's liability therefor was fixed by the terms of the contract. On the other hand, the operation of the principle of depletion depends upon exhaustion of resources through production—i.e., the recovery of capital through its conversion from the form of oil resources or reserves into marketable products or the equivalent received for such product. Under such principle the depletion allowance for the year or years of the bonus payments can only be measured by reference to the oil produced. If, as we have pointed out, the bonus is income, no part of which represents recovery of capital, it follows that any depletion allowance against such income is a departure from the depletion concept. The regulation relied on by the respondent is clearly such a departure. While it might, in some cases at least, produce a more equitable result, the statutory allowance may not be so varied by administrative regulation."

The correctness of the Board's conclusion as to the nature of the instrument of December 1, 1913, and its conclusion that no capital was returned to the taxpayer by virtue of the bonus has been discussed in Point I. There remains to be discussed the depletion concept which the petitioner contends is violated by the amended regulation sustained by the Circuit Court of Appeals.

Article 215 (a) as amended, *supra,* purports to be an interpretation of section 234 (a) (9) of the Revenue Act of 1918 which provides for a depletion deduction.

In a number of cases this Honorable Court has adopted for the word "depletion" its plain, ordinary and natural meaning* and has held that depletion is measured by and is limited to the amount of product mined and sold during the year.

In *United States* vs. *Ludey, supra,* at page 302, this Court, referring to the depletion provision said:

> "The depletion charge * * * represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment."

Again in *Lynch* vs. *Alworth-Stephens Co.,* 267 U. S. 364, this Court said, at page 369 (italics ours):

> "In the case of mines, a specific kind of property, the exhaustion is described as depletion, * * *. The interest of respondent under its leases in the mines being property, its right to deduct a reasonable allowance for exhaustion of such property, *if there be any,* during the taxable year, results from the plain terms of the statute, such deduction, since the property is an interest in mines, to be limited to the amount of the exhaustion of respondent's interest caused by the depletion of the mines during the taxable year. We agree with the circuit court of appeals * * * that 'the plain, clear, and reasonable meaning of the statute seems to be that the reasonable allowance for depletion in case of a mine is to be made to every one whose property right and interest therein have been depleted by the extraction and disposition "of

---

* *DeGanay* vs. *Lederer, supra.*

> the product thereof which has been mined and sold during the year for which the return and computation are made" * * *."*

The idea of exhaustion of reserves as fundamental to the meaning of the word depletion has been given emphasis by the Board of Tax Appeals in its opinion approved by this Court in the *Thompson* case, *supra*. The Board said (15 B. T. A. at page 997):

> "That a reasonable allowance for the depletion of a wasting or exhaustible asset, such as we have here, will be obtained by considering that the recoverable value will become exhausted in the same ratio as that which gives value to the asset disappears, can hardly be questioned. Lynch *v.* Alworth-Stephens Co., 267 U. S. 364. For example, if at January 1, 1917, a taxpayer had purchased a leasehold for the recovery of oil at a cost of $100,000 with oil to be recovered of 400,000 barrels, and if, during 1918, 100,000 barrels had been produced, a depletion allowance of $25,000, or 25 cents per barrel would certainly be accepted as the reasonable depletion allowance for 1918."

---

* See also *Stratton's Independence, Limited* vs. *Howbert, supra; Von Baumbach* vs. *Sargent Land Co.*, 242 U. S. 503; *Goldfield Consolidated Mines Co.*, vs. *Scott*, 247 U. S. 126. In all of these cases the depletion or "depreciation" claimed was on the basis of tonnage or other unit produced during the taxable year. In the *Von Baumbach* case this Court said, page 525 (italics ours):

> "It is equally true that there seems to be a hardship in taxing such receipts as income, without some deduction *arising from the fact that the mining property is being continually reduced by the removal of the minerals.* But such consideration will not justify this court in attributing to depreciation a sense which we do not believe Congress intended to give to it in the Act of 1909."

In the *Goldfield* case the terms "depletion" and "exhaustion" were used synonymously. See statement of questions presented, 247 U. S., at page 130.

The regulations promulgated by the Commissioner repeatedly refer to the exhaustion of the mineral and timber reserves as a basis for computing depletion.* The attention of the Court is also directed to A. R. M. 148, C. B. I-1, p. 186, in which it is stated, at page 187:

> "Where no mineral is produced upon the premises it follows that the interest of the taxpayer in the mineral reserves is not affected and that no allowance can be made for depletion."

In A. R. R. 1147, C. B. I-2, p. 138, this principle was extended even to advance royalties. It is stated in this ruling that, at page 139:

> "* * * a taxpayer who received during 1917 advance royalties on coal to apply against future mining operations was not entitled to a depletion deduction from income because no coal had been extracted."

The above line of cases establishes the meaning of the word "depletion" and associates it definitely and finally with exhaustion of the depletable property. The absolute condition precedent to the allowance of the deduction for depletion is the exhaustion or consumption of the reserves which are subject to depletion. The Commissioner's regulation, which requires the deduction of depletion with respect to a bonus not related to production, is therefore in direct conflict with the statute. No one disputes the fact

---

* As an example, see Article 210 of Regulations 45 which says that depletion "attaches to the annual production" and Article 229 of Regulations 45, which states that the allowance for depletion of timber in any taxable year "shall be based upon the number of units of timber felled during the year." Corresponding provisions are contained in the later regulations (Reg. 62, Art. 210, 229; Reg. 65, Art. 211, 231; Reg. 69, Art. 229; Reg. 74, Art. 249).

that the taxpayer is entitled to depletion in the instant case aggregating $15,710,899.52, the established market value at March 1, 1913, of the taxpayer's property. The real issue is how much of this depletion the taxpayer is entitled to deduct in the taxable years 1919 and 1920. It is for that reason that the principle allocating depletion to extraction or exhaustion, as opposed to the receipt of income, becomes important.

It becomes necessary, therefore, to discuss the decision of this Court in *Burnet* vs. *Thompson Oil & Gas Co., supra.* In that case this Court had under consideration the question whether in determining depletion under the 1918 Act there should be deducted from the depletable base the depletion actually sustained in earlier years or only so much of the actually sustained depletion as had been allowable as deductions under earlier revenue acts which allowed only a percentage of production as depletion. This percentage allowance had, as a matter of fact, fallen about $85,000.00 short of the depletion actually sustained, *i. e.,* the amount by which the reserves of oil had been exhausted. The taxpayer argued that only the depletion *allowed* should be used to reduce the depletable base. The Commissioner argued that the entire amount of *sustained depletion* should reduce the depletable base. This Court sustained the Commissioner. The opinion states, at page 306:

> "The tax is an income tax for 1918, and in the absence of express provision to the contrary, it is not to be supposed that the taxpayer is authorized to deduct from that year's income, depreciation, depletion, business losses or other similar items attributable to other years. * * * The construction adopted by the Court below in effect results in including in the taxable year items referrable to other

years, and is contrary to the theory of a tax for specific years.

"The nature of the tax as one for annual periods has been repeatedly mentioned in dealing with its application in various situations. The taxable year 1918, and that only, is involved, and deductions applicable to that year only should be allowed."

The taxes in the instant case are income taxes for the years 1919 and 1920. In the absence of express provision to the contrary, it is not to be supposed that the taxpayer is to be denied deductions for depletion actually sustained in those years because of theoretical depletion deductions (not based upon exhaustion) which the Commissioner now wishes to allocate to prior taxable years.

The construction adopted by the Commissioner is contrary to the theory of a tax for specific years. The nature of the tax as one for annual periods has been repeatedly mentioned in dealing with its application in various situations. The taxable years 1919 and 1920, and those only, are involved in the instant case, and deductions applicable to those years and granted by the statute should be allowed.

This is the thoroughly established depletion concept, sanctioned by this Court in the *Thompson* case, *supra,* and which the Board said the Commissioner had departed from in the case at bar by deducting the bonus from the taxpayer's depletable base. The Commissioner himself has never made any attempt, except in bonus cases, to apply the principle upon which must rest his treatment of the bonus in the instant case.

Since a bonus and ordinary royalties are both income,* there is no legal justification for making a distinction with

---

* See page 20, footnote *.

respect to depletion allowance between a lessor receiving a cash bonus and a lessor not receiving a cash bonus. Moreover, depletion and depreciation are kindred deductions* and if the depletion deduction is to depend upon income as the Commissioner's amended regulation requires, then certainly the depreciation and obsolescence deductions should likewise depend upon the amount of income received.

There is no need to dwell on the radical and far-reaching consequences of the general acceptance for all depreciation and depletion cases of the doctrine of Article 215 (a) as amended. The doctrine is irreconcilable with the underlying principle governing the computation of depletion in non-bonus cases. Its acceptance would mean that the production *of the year* would be abandoned as determining the taxpayer's depletion allowance *for the year* and that the allowance would be determined on a *dollar* basis instead of a *barrel* basis. This would mean that the exhaustion of depletable property would have no relationship to the depletion allowance and that instead the depletion allowance would fluctuate according to such irrelevant, fortuitous and variable considerations as the price of oil. There would be no stability of method left in determining the annual depletion allowance. The allowance could never be determined with the accuracy inherent in the method invariably employed in cases not involving a bonus. The general acceptance of the concept of regulating depletion for the year according to income would place depletion on a wholly artificial basis and introduce into the administration of the depletion provision almost insuperable difficulties.

The allowance for depletion and the allowance for depreciation of improvements on mineral properties are in-

* *United States* vs. *Ludey, supra.*

timately connected in the statute, provision being made therefor in the same paragraph, this type of depreciation being provided for separately from depreciation generally with respect to other types of property. It may be wondered parenthetically why Article 215 (a) of Regulations 45, as amended by Treasury Decision 3938, *supra,* is restricted to *depletion.* No reason whatever appears why depreciation of improvements, which is also frequently computed according to the unit-of-production method, should not also be determined on an income basis, a part of the depreciation of improvements being allocated to any bonus received. In this respect the Commissioner has failed to carry to its logical conclusion the principles of determining the deduction on an income basis.

The depletion provisions of the 1918 Act are unambiguous. Where that is true of a statutory provision, there is no room for construction and interpretation or a reference to matters of expediency. However, whatever doubt may lurk in the statute should be resolved by referring to an interpretation which will save inconvenience, injustice and confusion.* It would be difficult, if not impossible, to devise a more sensible and practical method of computing the depletion allowance for a taxable period than by reference to the exhaustion taking place in that period. The formula adopted in Article 215 (a) as amended, has as one of its elements "royalties expected to be received" from the property. Who can tell with the slightest pretense of precision in the early years of operation what these royalties will be? The speculative character of any estimate or prophecy of them is obvious. This introduces a highly

---

* *Woolford Realty Co., Inc.* vs. *Rose,* 52 S. Ct. 568; *Bankers' Trust Co.* vs. *Bowers,* 295 Fed. 89 (C. C. A. 2d, 1923).

problematical factor into the computation of depletion on the basis of income.* The probable result is that the depletion for a particular year will be measured not by income but by an inaccurate estimate of income; thus, not even the result theoretically intended is accomplished. It could not, as a matter of fact, be accomplished until the exhaustion of property and until the entire income derived therefrom became a known quantity. Only then may income serve accurately as the basis for the division of the depletion allowance among the years.

On the other hand, the production or barrel basis for calculating depletion reaches a result of absolute accuracy each year. The problem before Congress was to provide an accurate depletion allowance that could be given to taxpayers within a reasonable time, not in the dim future when the property became finally exhausted. Is it to be for a moment supposed that in using the word "depletion" Congress had in mind the adoption of a meaning for the term which would produce such absurd results?

Even more disastrously far-reaching consequences of any general acceptance of the principle underlying the Commissioner's treatment of the bonus in the instant case should perhaps be placed before the Court. In bonus cases, where the bonus is payable independently of production, it is never certain until there is production that the property will be exhausted. Many easily imaginable interventions may occur resulting in no production whatever. In the instant case the Standard Oil Company after paying

---

* This Court in *Burnet* vs. *Logan*, 283 U. S. 404, at page 412, said:

> "The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation."

the bonus, for any number of conceivable reasons, might never have produced a drop of oil from the Whittier and Coyote fields. It might have concluded, after making the lease and paying the bonus, that it could not profit from production from the property, that it had made a bad bargain, and it might completely have abandoned the lease. For many other reasons the lease might have been forfeited before any oil was produced. The result of the Commissioner's theory of depletion would be that a taxpayer would have offset income with depletion which never occurred. After receiving millions of dollars from the property, the property might be returned to the taxpayer with no diminishment whatever of its reserves of oil.* Is it conceivable that Congress could have intended to allow depletion to a taxpayer under such circumstances?

The ordinary meaning of the word "depletion," which must be resorted to, ** refers to exhaustion of the depletable property.

---

* This difficulty is recognized in Article 215(d) of Regulations 45 (and corresponding later regulations) in the provision for expiration, termination or abandonment of a lease without the removal of any or all of the mineral. Under Paragraph (d) of both the 1920 Edition of Article 215 and the Article as amended by Treasury Decision 3938, *supra*, the lessor is required to restore to capital account the excess of depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of operations and the corresponding amount must be returned as income for the year in which the lease expires, terminates or is abandoned. Would it not be simpler, and distort income less seriously, to recognize exhaustion in the first instance as the factor governing the depletion allowance? The effect of the procedure outlined in the regulation is a transfer of bonus income from the earlier year of receipt or accrual to the later year of abandonment,—a distortion which would be wholly unnecessary if the first incorrect step were not taken of placing depletion in the wrong year. The provision shows an attempt to correct one mistake by making another. In this connection see page 52.

** *De Ganay* vs. *Lederer, supra.*

Neither the Commissioner nor the Secretary of the Treasury can by his regulations alter or amend a revenue law, nor put into the body of the statute a limitation which Congress did not think it necessary to prescribe. *Morrill* vs. *Jones,* 106 U. S. 466.

The applicable principle has been nowhere more strikingly stated than in the opinion of this Court in the case cited so frequently against this taxpayer, *Lynch* vs. *Alworth-Stephens Co., supra,* in which it was said at page 370:

> "'* * * And the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover.' "

To allow a deduction independently of exhaustion is plainly to misapply and pervert the "obvious and rational meaning" of the statute. It leads into practical complexities of calculation that are almost insurmountable and which would enormously increase the difficulty of administering the income tax law. Where Congress has so plainly indicated by the use of the word "depletion" that it preferred the simple practical method of allowing a return of capital as exhaustion takes place, the congressional intent should be respected and the Commissioner's attempted reconstruction of the depletion provision by Article 215(a) as amended on November 13, 1926, should be declared invalid.

POINT III.

Neither the apportionment clause in the depletion provision of the 1918 Act, nor the decision of this Honorable Court in *Lynch* vs. *Alworth-Stephens Co.*, 267 U. S. 364, justifies any elimination from the taxpayer's depletable base on account of the bonus received by it under its lease.

The opinion of the Circuit Court of Appeals indicates that its decision was greatly influenced by the apportionment clause of Section 234 (a) (9) of the Revenue Act of 1918, reading:

> "In the case of leases the deductions [for depletion and depreciation] allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

We believe that the interpretation placed upon the apportionment clause by the Circuit Court of Appeals is entirely erroneous. It suggested that the apportionment clause applies to leases made *after* February 28, 1913, as well as those in effect at March 1, 1913; and it said that the bonus, which is the lessee's cost, must be applied in reduction of the lessor's value at March 1, 1913. The Court of Appeals of the District of Columbia in the case of *Night Hawk Leasing Co.* vs. *Burnet*, 57 F. (2d) 612 (App. D. C. 1932), reversing 19 B. T. A. 258, has gone even further and has held that the making of a lease after February 28, 1913, has the effect of transferring to the lessee a part of the lessor's depletable base-value at March 1, 1913.

Both of these courts construe the apportionment provision in such a way that a lessor making a lease after February 28, 1913, will never receive free from tax by way of depletion allowance the cost of its property or its value at March 1, 1913. The taxpayer in the instant case contends that such an interpretation is violative of the plain language and clear intendment of the depletion provision. The petitioner's contention is that the provision must be interpreted in such a way as to enable the return tax-free to the lessor of cost or value at March 1, 1913. It is submitted that this provision applies only to lessors and lessees under leases in existence on March 1, 1913. But even if it applied to leases made after this date, the taxpayer contends that the apportionment provision still requires the apportionment not only of the lessor's deduction but of all the deductions provided for.

The apportionment clause provides for the apportionment of "the deductions allowed by this paragraph." What are these deductions? They are plainly for depreciation of improvements and for depletion upon one of the three following bases: (1) cost; (2) March 1, 1913, value; (3) discovery value. The granting part of the section, the language giving the deduction, is the first part. As applicable in the instant case there is a clear and unambiguous grant of a depletion deduction based upon the fair market value of the property (or the taxpayer's interest therein) on March 1, 1913, in lieu of cost up to that date. There is nothing equivocal about this language. Its fundamental purpose is clear; it is to afford taxpayers retaining natural resources the same protection as is afforded by the Constitution to taxpayers who sell such property. The provision is a recognition of the fact that the proceeds of the sale

of the products of such wasting properties have in them capital which should not be subjected to tax.

It is an elementary rule of statutory construction that all parts of a statute should be read together and that one part should not be allowed to defeat another part if by any reasonable construction the two can be harmonized.* It is not difficult to harmonize the granting part of this depletion provision and the apportionment clause at the end thereof. Its obvious meaning is to apportion the value at the basic date, March 1, 1913, or date of discovery, among the various interests existing in the property at that date so that each interest will secure the return, tax-free through annual deductions for depletion and depreciation, of its total capital interest. This meaning is completely in harmony with the earlier part of the provision and does not take away from taxpayers what is unequivocably given, viz: an allowance for depletion and depreciation on the bases stated.

We may now turn to the interpretation placed upon the apportionment clause by the opinion of the Circuit Court of Appeals in the instant case. That opinion discusses the bonus question both on principle and authority. The conclusion reached on "principle" is to the effect that the fee valuation of $15,710,899.52 represented the total interest at March 1, 1913, of the taxpayer as *lessor* and of the Standard Oil Company as *lessee* and that no greater sum should be depleted. It is said (R. II-282):

> "The allowance of the total depletion to the lessor, as was required by the decision of the Board of Tax Appeals, left nothing to be apportioned to the interest of the lessee in the property."

---

* *Blair* vs. *Chicago*, 201 U. S. 400; *United States* vs. *Ninety-Nine Diamonds*, 139 Fed. 961 (C. C. A. 8th, 1905), affirming 132 Fed. 579.

It should be said parenthetically that the above-quoted remarks of the Circuit Court of Appeals are *obiter dicta* and were entirely unnecessary to its real decision, which indeed is inconsistent with the language quoted. Instances are numerous in which there is no March 1, 1913 value and no cost to the lessor of the mineral reserves and in which bonuses in substantial sums have been received for mineral leases. It would be interesting to speculate as to what the Circuit Court's opinion would have been if the Murphy Oil Company had had no March 1, 1913 value or cost. The Circuit Court said by way of *dicta* that no greater basis could be allowed the combined interests than the March 1, 1913 value of the lessor's interest. Would the Court then refuse depletion altogether to a lessee paying a bonus to a lessor having no March 1, 1913 value?

The *dicta* that not more than $15,547,522.17 (value at December 1, 1913 as assumed by the Circuit Court of Appeals though there was nothing in the record to show value at that date) should be depleted after November 30, 1913, by lessor and lessee cannot be reconciled with the later conclusion of the opinion that Article 215 of Regulations 45, as amended by T. D. 3938, *supra,* is valid. That regulation, to put it simply, permits depletion *to the lessor* with respect to the *entire* March 1, 1913 value. It simply rules that part of that value should be applied against the bonus by providing that the taxpayer lessor shall be entitled to deduct as depletion ". . . that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received."

The thought of the Circuit Court of Appeals in the *dictum* quoted appears to be that the statute provides for

a value at March 1, 1913, in the case of properties owned prior to that date, a part of which value is taken as a depletable base by all persons subsequently acquiring an interest in the property, and that the aggregate depletable bases of all parties in interest must never exceed that unchangeable depletable base represented by the value of the property at March 1, 1913.

In support of this line of argument the Circuit Court of Appeals refers to the apportionment clause at the end of Section 234(a)(9) and the interpretation given to the clause by this Honorable Court in the case of *Lynch* vs. *Alworth-Stephens Co., supra.* It is submitted that the Circuit Court of Appeals has failed to comprehend the real meaning of the apportionment clause and has misapplied the decision of this Honorable Court in *Lynch* vs. *Alworth-Stephens Co., supra.*

In the *Night Hawk Leasing* case, *supra*, the Phelps Dodge Corporation owned a copper property on March 1, 1913, which had a value establishing a depletion unit per pound of 4.11 cents. The appellant in 1919 leased the property from the Phelps Dodge Corporation. The lease provided for a specific royalty payable as copper was removed and provided for no acquisition cost, advance royalty or bonus. In 1922 the Phelps Dodge Corporation and the appellant made an agreement apportioning the 4.11 cents per pound between them, 3 cents a pound to the appellant and 1.11 cents to the lessor, Phelps Dodge Corporation. The Commissioner objected to the allowance of any depletion to the appellant, contending that the appellant had no cost for the lease, did not hold the lease on March 1, 1913, and was not entitled to discovery value. The Court, after quoting a portion of the apportionment clause of the 1921

Act (which is identical in language with that of the 1918 Act herein involved), said, at page 614:

> "Accordingly, if the owner of a claim be entitled under any one of these provisions to a depletion deduction in case the claim be operated by him alone, such deduction shall be equitably apportioned between such owner and lessee if the claim be operated by a lessee. This is the case regardless of whether the lease was acquired by the lessee prior to March 1, 1913, or subsequent to that date without 'acquisition cost, advance royalty, or bonus,' and without discovery by the lessee. The equitable interest of the lessee in the leased mine, upon which the depletion allowance depends, results from the mutual covenants of the parties in the lease. The lessee thereby acquired certain property rights in the mine."

After the above quotation, the Court refers, as does the Circuit Court of Appeals in the instant case, to the decision in *Lynch* vs. *Alworth-Stephens Co., supra.*

Under the statutory provision value at March 1, 1913, is taken "in lieu of cost up to that date." The purpose of this substitution of March 1, 1913 value for cost is plain. That date marked the incidence of the income tax and value at that date was regarded by Congress as representing cost. The apportionment clause relates to the "deductions allowed by this paragraph," one of which is cost and another of which is March 1, 1913 value substituted for cost. It seems clear that to qualify a lessee to share in the apportionment he must have some interest in the thing to be apportioned. He has that interest in March 1, 1913 value, if, and only if, the lease was in existence at that date. The same is true of discovery value. He can have no inter-

est in his lessor's cost arising after February 28, 1913. His interest by way of cost must grow out of his own cost of acquisition—not his lessor's.

This interpretation of the apportionment clause renders even more inescapable the fact that it was meant to apply only to situations in which there were two or more outstanding interests on the basic date. It is unthinkable that Congress could have meant depletion and depreciation deductions to be apportioned on account of every transaction in oil properties. If the broad meaning attributed to the clause by the Circuit Court of Appeals in the instant case and the Court of Appeals of the District of Columbia in the *Night Hawk* case is correct, the Commissioner is required to apportion the depletion and depreciation deductions constantly throughout the life of oil properties as various interests arise and accumulate. It would be necessary for the Commissioner to apportion the taxpayer's interest in the instant case if the taxpayer had purchased the property at March 1, 1913, for $15,710,099.52—if that had been the taxpayer's *cash* cost instead of value at March 1, 1913 of property acquired prior to that date. It would be necessary in the case of all taxpayers acquiring oil properties for cash subsequent to February 28, 1913, and thereafter leasing them. For example, a taxpayer might purchase fee ownership in oil properties in 1920 for a cost of $1,000,000.00 and lease the properties in 1922, with or without a bonus. The Commissioner under the broad meaning of the apportionment clause adopted in the *Night Hawk* decision and expressed in the Circuit Court of Appeals opinion in the instant case would be required to apportion between lessor and lessee this $1,000,000.00 cost to the fee-owner-lessor. In doing so the Commissioner would be say-

ing in effect that the fee-owner-lessor, who had paid $1,000,000.00 cash for the property, was not permitted to recover tax-free this $1,000,000.00 cash paid. This is the same as saying that this capital investment should not be returned as depletion but should be taxed under the guise of income.

The apportionment clause uses the word "equitably." It calls for equitable apportionment. Whatever may be the meaning of this word, it can hardly have been intended to take away from a taxpayer the right to the return tax-free of a cash investment in property subject to depletion. If this is true, it is an equally inequitable apportionment to take away from a taxpayer a part of his capital investment in property at March 1, 1913, which by the statute is substituted for cost, in the case of properties acquired prior to that date.

The word "apportion" should be given no stronger meaning than the word "equitably." The word "equitably" qualifies apportionment. While Congress may have had discretion to allow or not to allow depletion as a deduction, it is hardly conceivable that once it granted the depletion deduction it would have intended to allow taxpayers who themselves operate property the return of their entire capital interest tax-free and to allow other taxpayers who do not themselves operate the property the return tax-free of only part of their investment. This is an inevitable result of apportionment to the lessee where a lease is made after February 28, 1913, or after the acquisition by a lessor for a cash cost. The lessor still has the same interest in the property represented by a remainder interest and the lease; yet by reason of the lease a part of his interest in the property is no longer depletable.

Such an inequitable result could scarcely have been intended. It is far more reasonable to assume that Congress meant to treat all taxpayers similarly situated on an equal basis and that the apportionment clause means what its legislative history and the decision of this Court in *Lynch* vs. *Alworth-Stephens Co., supra,* indicates that it means—that all persons having an interest in property at March 1, 1913, should divide on a fair basis the depletion pertaining to the value at that date.

Doubt as to the meaning of the apportionment clause may be resolved by a reference to the situation confronting Congress when the clause was enacted. The 1916 Act contained no apportionment clause. Prior to the enactment of the 1918 Act it was being urged under the 1916 Act that *lessees* were not entitled to depletion upon the basis of value at March 1, 1913. In Regulations 33 Revised, interpreting the 1916 Act, it was ruled (Article 170) that in the case of an *operating fee owner* the amount returnable through the depletion deduction was the fair market value of the property as of March 1, 1913, and that in the case of a *lessee* the capital to be returned was the amount paid in cash or its equivalent as a bonus or otherwise by the lessee for the lease plus certain additional expenses.* The operating owner was permitted to take depletion on the basis of cost *or March 1, 1913 value,* if greater than cost; the lessee was limited to depletion based on cost, even though the lease was entered into or acquired prior to March 1, 1913, and had a value on that date greater than cost.

---

* See also T. D. 2447, unpublished, referred to in Part I, page 524 of Hearings Before Committee on Ways and Means on Revenue Act of 1918.

It needs no discussion to point out the injustice of this differentiation between lessors and lessees. It is obvious that the purpose of the apportionment clause was to correct the differentiation, and to insure depletion to *lessees* on the basis of the value of their leasehold interests at March 1, 1913. The legislative history of the apportionment clause reveals this purpose clearly.*

In the light of subsequent events the evil intended to be cured by the apportionment clause proved imaginery; the decision of this Honorable Court in *Lynch* vs. *Alworth-Stephens Co., supra,* announced after the enactment of the 1918 Act on February 24, 1919, effectively disposed of the Treasury's contentions that *lessees* were not entitled to depletion on the basis of value on March 1, 1913. However, the decision of this Court was not announced when the apportionment clause was first enacted and Congress apparently intended to make the matter doubly clear.

In the light of this legislative history the meaning of the apportionment clause becomes clear. The clause was intended to operate in cases in which there were on March 1, 1913, *both* a lessor and a lessee. This meaning is confirmed by an examination of the facts in the case of *Lynch* vs. *Alworth-Stephens Co., supra.* It is highly important that the leases involved in that case were in existence at March 1, 1913; there was involved no lease entered into after February 28, 1913, as in the instant case.

The question presented in *Lynch* vs. *Alworth-Stephens Co., supra,* was whether lessees were entitled under the 1918

* See Hearings Before Committee on Ways and Means, House of Representatives, on Proposed Revenue Act of 1918, Part I, pages 515-572; Hearings before Senate Finance Committee, 65th Congress, 2nd Session, H. R. 12,863, pages 356-371. See also Hearings Before Committee on Ways and Means, particularly pages 528, 545.

Act to depletion based upon value at March 1, 1913. It was held that where the lease was entered into *prior* to March 1, 1913, and *was in effect on that date* the total interest therein was to be divided between the lessor and lessee and that the value at March 1, 1913, of the *lessee's* interest therein was depletable. The theory adopted was that although the lessee might not have acquired the minerals in place, his privilege was a property right at March 1, 1913, the value of which should be returned to the lessee by the depletion allowance.

Even if this Court should decide that the apportionment clause had application to a situation such as is presented in the instant case in which the lease was entered into after February 28, 1913, there is no reason for giving to the clause an interpretation which deprives anyone of the right to deplete his capital investment in oil properties, whether that capital is represented by cost or value at March 1, 1913. This is clear from the language of the apportionment clause. What is to be apportioned? The statute says "the deductions allowed by this paragraph." The statute does not require the apportionment of only one deduction allowed by the paragraph; it requires the apportionment of all the deductions allowed. In the case of a lease entered into after February 28, 1913, the statute allows a deduction to the lessor based upon value at March 1, 1913, and to the lessee upon the basis of cost. Both of these deductions must be apportioned if the apportionment clause applies to situations in which leases have been entered into after February 28, 1913. If these deductions are to be equitably apportioned, the essential purpose of Congress must be kept in mind and the apportionment must be such that the lessor will secure the return tax-free of the value of his fee inter-

est at March 1, 1913, and the lessee will secure the return tax-free of the cost of his lease entered into after that date. What has to be apportioned is a deduction to the lessor-fee-owner based on the March 1, 1913, value *and* a deduction to the lessee based on its cost—in the instant case the bonus paid by the Standard Oil Company plus all improvement costs.

The vice of the *Night Hawk* decision is thus apparent. The taxpayer in that case had no cost, March 1, 1913 value, or discovery value. It had no deduction allowed by the paragraph. The *Night Hawk* decision requires apportionment to a lessee taxpayer not entitled to any depletion at all of part of the depletion to which its lessor was entitled. The effect of the decision is, therefore, to give to the lessee depletion which the granting clause of the statute does not allow, by taking away from the lessor depletion which the granting clause allows to it. This is not to apportion the "deductions allowed by this paragraph" among persons entitled to depletion; it is to apportion a deduction allowed by the paragraph between a person entitled to depletion *and a person who is entitled to no depletion whatever.*

The error of the Circuit Court of Appeals in the instant case is equally clear and is not essentially different because the lessee did have a cost by virtue of the payment of the bonus. There were two deductions allowed by the statute, one to the lessor, Murphy Oil Company, based upon the March 1, 1913, value, and the other to the lessee, Standard Oil Company, based upon the cash paid in the form of a bonus. The Circuit Court of Appeals construed the apportionment clause as requiring the allowance of deduction based upon the cash cost to the lessee *at the expense of the deduction allowed to the lessor.* This is not to appor-

tion "the deductions allowed by this paragraph." It is to apportion one deduction allowed by the paragraph based upon the March 1, 1913, value of the properties, and to make no apportionment whatever of the other deduction based upon the cost in the hands of the lessee, Standard Oil Company. It is an interpretation of the apportionment clause violating not only the language of the clause itself, which uses the plural in speaking of "deductions"; more seriously, it is a violation of the basic intendment of the section in that it precludes the return tax-free by way of depletion to the lessor of the value of its property at March 1, 1913.

The depletion provision has been described as a statutory recognition of the wasting character of mineral resources and the purpose of the provision is plainly to provide for taxpayers whose income is from natural resources a protection from tax upon capital. This purpose cannot be accomplished unless the taxpayer is enabled to receive tax-free by way of the depletion allowance the cost of its property or its value on March 1, 1913, if it was acquired prior to that date. Anything which prevents the recovery of this capital tax-free will frustrate the manifest purpose of Congress. The meaning attributed to the apportionment clause by the Circuit Court of Appeals in the instant case and the Court of Appeals of the District of Columbia in the *Night Hawk* case, strikes at the heart of this legislative intent. If the meaning is sanctioned, taxpayers owning property at March 1, 1913, who subsequently lease the property will never secure the return tax-free of the value of their interest in the property at March 1, 1913. Indeed, taxpayers who purchase property for cash will never secure the return tax-free of their capital invested in the prop-

erty after February 28, 1913. In the *Night Hawk* case the Phelps Dodge Corporation is obviously deprived of the return tax-free of approximately three-fourths of the value of its properties at March 1, 1913. In the instant case the same is true to the extent to which the bonus is applied in reduction of the taxpayer's capital sum. The reduction is lost to the taxpayer forever as a part of the depletable value of the taxpayer's interest at March 1, 1913, unless the Commissioner is correct in the theory that depletion should be determined on an income basis. The *Night Hawk* decision is completely unsound and cannot be sustained on any theory. It robs the lessor of depletion to which he is plainly entitled and donates that depletion in contravention of the statute to the lessee.

The opinion of the Circuit Court of Appeals in the instant case is equally indefensible. No excuse exists for reducing the capital sum on the theory suggested by it. There remains the theory that the amount of reduction is depletion properly allowable in years previous to the taxable years involved, viz., depletion allocated to the bonus years. Any attempted justification on this theory fails, however, for the reasons indicated under Point II and the decision of the Circuit Court of Appeals is therefore left wholly without support on principle or authority.

If the apportionment clause is to be held applicable in cases in which the lease of depletable properties is entered into after February 28, 1913, it follows that the depreciation of improvements allowance as well as the depletion allowance is subject to apportionment. Both allowances are granted by the paragraph and there is no basis for treating the one allowance differently from the other. In the instant case this would mean the apportionment not only

of the established value at March 1, 1913, but also of the cost of the lease to the Standard Oil Company represented by the bonus. It means also that there is subject to apportionment between the petitioner and the Standard Oil Company a deduction for depreciation based upon the cost of all improvements made by the Standard Oil Company upon the premises. This logical development of the application of the apportionment clause in cases in which the lease was entered into after February 28, 1913, shows the fallacy of any such application of the clause. However, if this interpretation is correct, the petitioner has obviously not received the deductions to which it is entitled and the case should be remanded in order that a proper apportionment may be made.

POINT IV.

The Commissioner's amended regulation is arbitrary, capricious and invalid.

(a)

Impossibility of Proving Royalties Expected to be Received.

Ordinarily it is not difficult to adduce proof of the fair market value of real property, whether that property be a city lot, a farm or mineral lands. Scientific methods have been devised which make it relatively easy to estimate with reasonable accuracy the number of barrels of oil which a given property will produce. These two factors—value and reserves—together with the production for the taxable period, are all that are necessary for the determination of depletion according to the unit-of-production method which

has been discussed. But to determine depletion attributable to a bonus by the method prescribed in Article 215 of Regulations 45, as amended, makes it necessary to introduce still another factor which the lower court describes in its opinion as (R. II-291) "* * * proof of the probable market value of the oil to be marketed under the lease in terms of dollars per barrel * * *." The lease herein involved, like most oil leases, did not provide for a fixed cash royalty per barrel, but leaves the royalties to be paid subject to the price of oil current at the time of production. There is accordingly no escape from the necessity of estimating the future price of oil in determining the royalties expected to be received.

The amended regulation requires in this respect proof of that which is not susceptible of proof. The "probable" market value of the oil to be marketed under the lease in terms of dollars per barrel is dependent upon the production and consumption of oil throughout the term of the lease, not only on the lease in question but throughout the whole world. The price of oil in terms of dollars per barrel necessarily fluctuates from time to time in accordance with supply and demand. Proof of this "probable market value" is so remote and speculative as not to be admissible in evidence. As illustrative of the impossibility of proof let us suppose that today one wished to establish the amount of royalties "in terms of dollars per barrel" expected to be received under the remaining term of the lease. It cannot be assumed that the present absurdly low price of oil will remain constant over the remaining term of the lease. It is an accepted fact that the price of oil, as the price of all other products, is always fluctuating. There is every reason to expect that in the future the price of oil will fluc-

tuate as it has in the past. Therefore, in estimating the amount of royalty expressed in dollars per barrel to be received during the remaining term of the lease the price now prevalent cannot be used. If today's price of oil cannot be used in estimating the expected royalties in dollars per barrel, what price then can be used? The regulation which has been approved by the lower court specifically requires that the anticipated net market price of oil be determined. Certainly no witness can be found who would be qualified and willing to testify to the future market price of oil to supply that factor essential in the formula approved by the Circuit Court of Appeals.

While it is possible to estimate the number of barrels of oil which a given group of wells will ultimately produce from a given sand or zone, their monthly production may be, and in a great many cases is, restricted because of a surplus in the world's visible supply of oil. That is the condition which exists today and is a matter of common knowledge. We know what the price of oil is today and we know the daily production of our wells, but we do not know when the world's visible supply of oil will be increased or decreased to such an extent that the price of oil will be decreased or increased. Fluctuation in the price of oil is caused by many factors other than increase in the supply. Demand, equally with supply, determines market price. The elements affecting demand are as numerous as the products which compete with oil, and as complex in their operation as our economic system itself. The discovery of a new fuel may make oil as antiquated as tallow candles; on the other hand, the development of new machines for transportation may enormously expand the oil market. Such a growth actually happened after this

lease was made—the tremendous increase in the use of automobiles. Similarly general changes in the value of money produce cyclical price fluctuations, blows which our economic system is repeatedly called upon to endure.*

From these observations, it is clear that it is impossible to prove even approximately or within a reasonable range the amount of money which will be received for each barrel of royalty oil at the time it is actually produced. It being impossible to determine this most essential factor, the formula as prescribed by the regulations and approved by the lower court is useless in determining the amount, if any, of depletion attributable to a bonus. That taxation is a practical matter is universally recognized by the courts. The law never requires impossibilities. Therefore, this regulation in requiring impossibilities is so arbitrary and capricious as to be invalid.

(b)

Differentiation Between Depletion in Bonus and Non-Bonus Cases.

The amended regulation is arbitrary, capricious and therefore invalid for the further reason that it is so wanting in a basis for classification as to produce a gross and patent inequality between lessors who receive a bonus and lessors who do not receive a bonus. The amended regulation places the computation of a lessor's depletion where a bonus is paid upon a money basis, while in the case of a lease with no bonus the production or exhaustion basis is prescribed by Article 214 of Regulations 45, which specifically requires the annual depletion deductions in non-

* See quotation from *Burnet* vs. *Logan, supra,* footnote *, page 30, *supra.*

bonus cases to be based upon the exhaustion of the mineral reserves. Amended Article 215 (a), however, requires depletion to be taken in respect of the bonus and further provides that the remainder of the depletable base is to be recovered "through depletion deductions *on the basis of royalties thereafter received,*" *i. e.,* on the basis of money thereafter received and not on the basis of the units of mineral thereafter produced.

(c)

Requirement that Excess Depletion be Returned as Income in Event of Termination of a Lease.

Paragraph (d) of Article 215 of Regulations 45, as amended by T. D. 3938, *supra,* is a supplement to paragraph (a) thereof and is necessary in the Commissioner's view to make the article workable. For the convenience of the Court this sub-paragraph will again be quoted in full:

> "Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

In paragraph (a) of Article 215, as amended, the Commissioner requires that the depletion be taken upon a cash receipts bases. He then requires under the provisions of paragraph (d) of the Article that the cash receipts basis of computing depletion provided for in para-

graph (a) shall be checked by reference to the actual depletion as a result of the operations under the lease. If it is found upon this check that the depletion theretofore taken was excessive it is to be restored to capital account and returned as income to the extent of the excess. It is quite apparent that the Commissioner recognizes but one correct method of computing depletion, that is, by reference to the exhaustion of the resources.

The principal point, however, to which attention is directed is the Commissioner's requirement that excess depletion of prior years be restored to income *in the year in which the lease expires, terminates, or is abandoned.* This requirement cannot be enforced for the fundamental reason that it is not within the Commissioner's power to define income. Income must be received or derived before even Congress has the power to levy a tax thereon without apportionment.* Whether the expiration, termination or abandonment of a lease produces income to the lessor is determined, not by reference to depletion deductions taken in years prior thereto, but solely by reference to the facts involved in connection with the expiration, termination, or abandonment of the lease. If he has received money or some property right of value in connection with the termination of the lease, then and then only can he be said to have had income taxable under the provisions of the Sixteenth Amendment to the Constitution and the revenue act in effect in the year of termination.

Paragraph (d) has been held invalid for the reasons given (*Kittie A. Knapp,* 7 B. T. A. 790; A. T. Cooper, 7 B. T. A. 798).

---

* *Brushaber* vs. *Union Pac. R. R. Co.,* 240 U. S. 1.

Conclusion.

The regulation is therefore invalid for three reasons:

(a) It requires the proof of a fact which is not susceptible to proof; (*i. e.*, "royalties expected to be received under the lease");

(b) It is unreasonable in classification in that it requires a computation of depletion in bonus cases different from that required in non-bonus cases, *i. e.*, dollars versus units of production; and

(c) It attempts to tax as income that which is not income under the Constitution or any revenue act yet enacted by Congress.

POINT V.

The history of Article 215, as amended, of Regulations 45 and the time of its injection into this case puts upon the Commissioner the burden of pleading and proving the allocation contended for by him.

A short history of the depletion provisions of the various Revenue Acts and the regulations and rulings promulgated by the Commissioner in interpretation of the statutes is of interest in that it demonstrates the vacillation of the Commissioner in the face of a steady policy of Congress.

The Corporation Tax Law of 1909 contained no provision for a deduction on account of depletion. It was held in *Stratton's Independence, Limited* vs. *Howbert, supra,* that the Constitution did not make it imperative that there be such an allowance.

However, the Congress was convinced that fairness required that a depletion deduction be permitted. Conse-

quently a depletion allowance was granted by the Revenue Act of 1913, and depletion deductions have been authorized by every subsequent act.*

The regulations did not treat bonuses separately until Regulations 45, 1920 edition, were promulgated January, 1921. Article 215 provided that bonus payments should be regarded as a return of capital to the lessor.**

This was directly contrary to earlier rulings of the Commissioner to the effect that bonuses were income and that no depletion deductions were allowable in respect thereof.

Again the Commissioner changed his mind. On November 13, 1926, he ruled that a bonus was income, subject, however, to a depletion deduction. Treasury Decision 3938, *supra.****

The first shift of position might well raise the suspicion of error when it is recalled that the Sixteenth Amendment remained unchanged and the statutory policy was constant.

The character of the bonus—capital or income—must also have remained the same. Either one position or the other was incorrect. The suspicion of error ripens into certainty with the second change of view on the part of the Commissioner, for the immutability of the governing factors still exists, and in addition there is injected the uncertainty of "expected royalties." It is clear that a regu-

---

* Subdivisions B and G(b), Section II, Revenue Act of 1913 (38 Stat. 114, 166); Section 5, Paragraph Eighth (a) and Section 12 (a), Paragraph Second (a), Part I, Title I, Revenue Act of 1916 (39 Stat. 756). The provision of the 1916 Act was adopted by the Revenue Act of 1917, Section 212 (40 Stat. 300). Sections 214 (a) (9) and 234 (a) (9), Revenue Act of 1918 (40 Stat. 1057). Similar allowances are granted by the later Revenue Acts applicable to years subsequent to those here involved.

** See page 7, *supra*.

*** The amended regulation is quoted in full, *supra*, page 8.

lation is entitled to little respect, unless it has been uniform, general, long-continued and reasonable.*

It was stated above that the last amendment of Article 215 was announced on November 13, 1926. It was not, however, until after the hearing of this case before the Board of Tax Appeals that the Commissioner adapted to this case the theories of his new creation, by applying the amended regulation to his brief, thus completely changing the issues.

The sole question presented to the Board on the record was whether or not the bonus payments in their entirety constituted a return of capital or income. That was the proposition upon which issue was joined and the case tried before the Board. By relying upon Article 215 as amended, the Commissioner has injected new concepts into the case.

It is recognized, of course, that the taxpayer has the burden of showing that the determination of the Commissioner (as shown in the sixty-day letter from which the appeal is taken) is in error, but this rule does not place the burden of proof upon the taxpayer to meet new propositions advanced by the Commissioner after the hearing. The Commissioner is an ordinary litigant subject to the rules of procedure which govern the conduct of suits and which, after all, are only aimed at common fairness. If he desires to propose new issues after the close of the proofs he is required to do so by appropriate pleading and the burden of proof is upon him to establish the allegations made therein. The Board of Tax Appeals held that the determination of the Commissioner as shown in his sixty-day letter, which is the basis of the appeal, was erroneous. It

---

* *Iselin* vs. *United States*, 270 U. S. 245; *Robinson* vs. *Lundrigan*, 227 U. S. 173.

would, therefore, logically follow that the decision of this Court should be in favor of the taxpayer.

The lower court, in its opinion, stated that (R. II-291):

> "* * * the Commissioner correctly determined that at least a part, if not all, of the bonus payment is to be treated as return of capital. The burden is on the taxpayer to show that the computation of tax by the Commissioner is erroneous, and there is a failure of proof in this case sufficient to permit allocating a part of the bonus payment to return of capital and part to income, under the above quoted regulation * * *."

The burden of proof does not extend beyond the scope of the hypotheses upon which the deficiency is asserted.

The amendment of Article 215 was not made until after the Commissioner had made his determination contained in the sixty-day letter. If the Commissioner intended to rely upon Article 215, as amended, he should have amended his pleadings before the Board and pleaded the postulate he now relies upon.

Any defense to the appeal of Murphy Oil Company by way of a new theory which the Commissioner desired to interpose should have been raised by affirmative allegations and supported by proof. The duty was upon him to do so.

Rule 14 of the rules of practice before the United States Board of Tax Appeals relative to the answer of the Commissioner provides (italics ours):

> "* * * The answer shall be so drawn as fully and completely to advise the petitioner and the Board of the nature of the defense. It shall contain a specific admission or denial of each material allegation of fact contained in the petition and *a statement* of

any facts upon which the Commissioner relies for defense or for affirmative relief * * *."

Rule 30 provides:

"The burden of proof shall be upon the petitioner, except as otherwise provided by statute and except that in respect of any new material pleaded in his answer, it shall be upon the respondent."

It is respectfully submitted that since the Commissioner failed to amend his pleadings in such a manner as to allege and prove the new issue injected into the case by his brief, the decision of the Board for that additional reason should be sustained.

Respectfully submitted,

RANDOLPH E. PAUL,
Attorney for Taxpayer,
40 Wall Street,
New York City.

THOMAS R. DEMPSEY,
A. CALDER MACKAY,
1104 Pacific Mutual Building,
Los Angeles, California.

KENYON F. LEE,
BRADNER W. LEE,
H. W. Hellman Building,
Los Angeles, California.

FERRIS D. STONE,
EDWARD S. REID, JR.,
Penobscot Building,
Detroit, Michigan.
Of Counsel.